Supreme Court, U. S.
FILED
FEB 23 1979
MICHAEL RODAK, JR., CLERK

No. 78-1062

In the Supreme Court of the United States

OCTOBER TERM, 1978

THOMAS K. MCMANUS, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. A 1-33) are reported at 65 T.C. 197. The opinion of the court of appeals (Pet. App. B 1-13) is reported at 583 F. 2d 443.

JURISDICTION

The judgment of the court of appeals was entered on October 4, 1978. The petition for a writ of certio-

rari was filed on January 2, 1979. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether subdivided and improved real property which is not a capital asset because it is held primarily for sale to customers in the ordinary course of business automatically becomes a capital asset upon the owner's receipt of a notice of condemnation of the property.

STATUTE INVOLVED

Section 1221 of the Internal Revenue Code of 1954 is set forth at Appendix, *infra*, pp. 1a-2a.

STATEMENT

Since 1954, petitioners have been in the land development business (Pet. App. A 21; Pet. App. B 2, 10). In 1961, petitioners purchased 36½ acres of prime industrial land (Tract 2347) in Oakland, California for $926,000. Shortly thereafter, petitioners sought and received the approval of the city planning commission to subdivide and improve the parcel. Between March and September, 1962, they spent approximately $240,000 for the installation of roads, sewer lines, and water, gas and electrical facilities (Pet. App. A 7-8; Pet. App. B 2-3).

During 1964-1970, the tract was listed for sale on various occasions in the Western Real Estate News, the California Site Selection Handbook, and a publi-

cation of the California State Chamber of Commerce. Each of these publications received wide circulation within the real estate industry (Pet. App. A 12-13; Pet. App. B 3-4.[1] As a result, it was generally known among real estate brokers that the tract was available for industrial or commercial development (Pet. App. A 12).

During 1962-1973, petitioners disposed of all of the subdivided parcels of the tract in 15 sales or exchanges and earned a gross profit of more than $2 million (I-R. 122-126).[2] During the course of selling the lots, petitioners made several sales to governmental entities and recognized that such entities were potential purchasers of lots (Pet. App. A 32; Pet. App. B 11; II-R. 165-166). Although petitioners had leased certain lots in the tract during 1963-1973, all of the leases were for short periods and resulted in nominal rental income (Pet. App. A 11-12; Pet. App. B 3).

In 1968, petitioners sold a portion of the tract to the State of California. The sale was accomplished by means of a condemnation proceeding because the parties were unable to agree on a price for that particular parcel (I-R. 125). The State's purchase of the property and the condemnation proceeding

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[1] Petitioners did not authorize these listings which were made free of charge. However, they were fully aware of such listings and made no effort to terminate them (Pet. App. A 12-13; Pet. App. B 4).

[2] "I-R." and "II-R." refer to the two-volume duplicated record filed in the court of appeals.

were prompted by its desire to construct a freeway interchange on a part of the tract. After they learned of the proposed condemnation, petitioners were concerned that the State's delay in acquiring funds for the highway construction and completing acquisition of the property would interfere with the sales of the remaining parcels of the tract. As one of the petitioners stated in a letter to the State, the delay was "seriously and adversely affecting our use of the property as well as its present saleability" (Pet. 4-5). Similarly, one of the petitioners testified at trial that the condemnation activity and resultant delay "really hurt our sales on the development. It really put a bug in the whole thing" (II-R. 26).

On audit of petitioners' taxable years 1968-1970, the Commissioner determined that the entire tract, including the parcel condemned by the State of California, was held primarily for sale to customers in the ordinary course of petitioners' business. As a result, the Commissioner took the position that the gains realized by petitioners from the sales of the various parcels were taxable as ordinary income. The Tax Court upheld the Commissioner's determination. In its view (Pet. App. A 32), "the condemnation element did not bring any unexpected customers to the partnership's door, but rather served as the means by which the sale was conducted. We see no reason then why the gain produced by the sales to its governmental customers should be treated any differently than the gain realized by sales to its other customers."

The court of appeals affirmed (Pet. App. B 1-13). It held that petitioners' sale of the parcel to the State was in the ordinary course of their business because they had negotiated with various governmental entities for the sale of other parts of the tract, had actually sold one parcel to a State agency, and had transferred the parcel at issue by condemnation only because they were unable to agree on the price (Pet. App. B 11-12).

ARGUMENT

1. Section 1221 of the 1954 Code defines the term "capital asset" negatively by providing five exclusions from the general descriptive phrase "property held by the taxpayer." The first statutory exclusion states that a capital asset shall not include "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The decision below correctly held that the gain from petitioners' sale of a parcel of land to the State of California was taxable at ordinary income rates because it was "property held by [them] primarily for sale to customers in the ordinary course of [their] trade or business."

Petitioners contend that even on the assumption (Pet. 7-8) that they held the parcel at issue for sale to customers in the ordinary course of business, the receipt of the condemnation notice from the State automatically changed their purpose to one of holding the parcel solely for investment. But the receipt of a notice of condemnation did not change petitioners' essential purpose with respect to the property. As

the courts below observed, prior to the issuance of the notice of condemnation, petitioners had negotiated with various governmental entities for the purchase of their property (Pet. App. A 32; Pet. App. B 11). For example, there had been negotiations for the construction of a post office; in 1962 the City of Oakland purchased one parcel (Pet. App. A 32); and in 1970 the State of California purchased another parcel for use as a motor vehicle bureau office (Pet. App. B 11). In selling the parcel in issue to the State in 1968 through condemnation, petitioners did not change their purpose from one of sale to investment; the condemnation was simply the mechanism to carry out the sale when the parties were unable to agree on a price (Pet. App. A 32-33; Pet. App. B 11-12).

2. Contrary to petitioners' argument (Pet. 6-7), there is no conflict between the decision below and that of the Tenth Circuit in *Commissioner* v. *Tri-S Corp.*, 400 F.2d 862 (1968) affirming on another ground 48 T.C. 316 (1967). There, the Tax Court held that land which was held primarily for sale to customers in the ordinary course of the taxpayer's business of improving the land and building residences automatically ceased to be so held after receipt of a condemnation notice from the state highway department. As the Tax Court saw the matter, the sale to the highway department was qualitatively different from the taxpayer's previous sales and was therefore not "in the ordinary course of its business." However, the Tenth Circuit did not affirm *Tri-S* on the theory of the Tax Court. To the contrary, it

sustained the taxpayer's claim to capital gains treatment on the sole ground that the taxpayer held the land for investment before receipt of the notice of condemnation, and therefore it had never held the property for sale to customers in the ordinary course of its trade or business. While the Tenth Circuit acknowledged that the taxpayer intended at some time in the future to improve the land, it concluded that it "would have been futile for it to have undertaken to carry out such future plan" after reciept of the notice of condemnation (see 400 F.2d at 864). See also *Juleo, Inc.* v. *Commissioner*, 483 F.2d 47, 49 (3d Cir.), cert. denied, 414 U.S. 1103 (1973). Here, on the other hand, petitioners held the land for sale prior to the receipt of the notice of condemnation. As the Tax Court pointed out in refusing to apply its *Tri-S* rationale to the facts of this case, "the condemnation element did not bring any unexpected customers to the partnership's door, but rather served as the means by which the sale was conducted. We see no reason then why the gain produced by the sales to its governmental customers should be treated differently than the gain realized by sales to its other customers" (Pet. App. A 32). *Tri-S* is therefore distinguishable.[3]

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[3] Petitioners also argue (Pet. 4) that prior to the notice of condemnation their purpose in holding the property was to lease it rather than to sell it to customers, and that this purpose continued after the notice of condemnation. But the Tax Court and the court of appeals rejected this argument (Pet. App. A 11-12, 30; Pet. App. B 10) on the ground that the leasing activity was "nominal." This factual determination does not warrant further review.

Similarly, there is no conflict with the decision of the Fifth Circuit in *Ridgewood Land Co.* v. *Commissioner*, 477 F.2d 135 (1973), affirming per curiam 31 T.C.M. 39 (1972) (Pet. 6-7). There, the Tax Court upheld capital gains treatment on two independent grounds. First, in conformity with its *Tri-S* holding, it concluded that a notice of condemnation automatically changed the character of property held primarily for sale to customers to that of a capital asset. Secondly, it found that when the taxpayer learned of the state's intention to institute eminent domain proceedings, it changed its original purpose with respect to the property and thereafter held it for investment. As a result, the gain from a subsequent sale, which was made to a third party and not to the condemning governmental authority, was held to be taxable as capital gain.

The Fifth Circuit affirmed. By underscoring the phrase "under the particular facts of the case" and setting forth the Tax Court's finding concerning the taxpayer's change of purpose, the Fifth Circuit's per curiam opinion emphasized the restricted scope of its holding (477 F.2d at 136). Since the Fifth Circuit's opinion does not cite the Tax Court's *Tri-S* decision, there is no conflict between the decision below and *Ridgewood*.[4]

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[4] We recognize that the court below read *Ridgewood* as upholding petitioners' argument that "once the State * * * began condemnation proceedings, their holding of the condemned parcel changed to one for investment because the taxpayers could no longer sell the property" (Pet. App. B 11). But given the Fifth Circuit's emphasis upon the "particular facts of the case," we submit that the decision narrowly turned on the taxpayers' change of purpose rather than on the broad rationale of the Tax Court in *Tri-S* that condemnation automatically results in a change of purpose.

In short, neither the Tenth nor the Fifth Circuit has adopted the rationale of the Tax Court's *Tri-S* holding that a notice of condemnation of itself automatically changes the character of property held primarily for sale to customers in the ordinary course of business to a capital asset. Nor did the Tax Court believe that its *Tri-S* rationale was applicable to the facts of this case. There is therefore no conflict among the circuits.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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FEBRUARY 1979

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade of business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person

whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

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